PRESS RELEASE

US: ECONOMIC RESILIENCE COULD BE FURTHER TESTED BY A DEBT CEILING SHOWDOWN

Bucharest, May 24, 2023 – Janet Yellen recently warned that the US could run out of cash as early as June 1st if Congress does not suspend or raise the debt limit. As a reminder, the debt ceiling is set at 31.4 trillion USD, an amount reached in January 2023. Since then, the federal government has relied to "extraordinary measures" to meet its obligations. Yellen has urged lawmakers to reach an agreement with the Biden administration as soon as possible to avoid financial and economic turmoil. But, while the White House continues to push for "clean" increase of the debt ceiling, Republicans, who took control of the House of Representatives after the 2022-midterm elections, insist on deep spending cuts as a precondition. As the deadline approaches and a political compromise remains distant, a rise in risk aversion could weigh on the US dollar and push Treasuries yields higher. This add a challenge for the US economy, which is already facing high inflation and interest rates and turbulence in the banking sector.

Raising the debt ceiling: from quasi-formality to political weapon

While the U.S. debt ceiling has been regularly raised or suspended in the past, it is now the subject of increased debate and manoeuvring, with opposition parties using it as a political weapon. The standoff over the cap between the Obama administration and Republicans in 2011 was the most striking example. The crisis led S&P to downgrade the US government's credit rating to AA+. Although a national default was avoided, the dollar weakened and Treasury yields rose.

More recently, the limit was last raised in December 2021, when the Democratic Party had a slim majority in Congress. However, brinkmanship over the issue has looked increasingly likely after the Republicans regained control over the House of Representatives following midterm elections in November 2022. On April 19th, the Republican Speaker of the House unveiled a bill linking a USD1.5 trillion debt ceiling increase to an estimated USD4.5 trillion in spending cuts over the next decade. The plan was immediately rebuked by the Biden administration and is unlikely to be approved by the Democratic-controlled Senate. As the deadline approaches, negotiations have resumed between the Democratic administration and the Republicans, but positions remain far apart for the time being.

A default would have cascading consequences

A default would have dire consequences for the financial markets, for the economy, but also on the political level. Republicans and Democrats therefore have an incentive to reach an agreement and a last minute compromise remains likely. However, we cannot completely rule out a default by accident caused by the increased polarization of the US political landscape. A number of workarounds are being debated to avoid a crisis:

- **A discharge petition to force a vote on the debt limit:** if negotiations between the White House and Congress fail, House and Senate Democrats could force a vote on a debt ceiling increase.
- **Joe Biden invokes Section 4 of the 14th Amendment to the Constitution.** Under one interpretation of this amendment, the President could override Congress and force the Treasury to issue government bonds to meet its obligations. However, this would likely lead to a constitutional crisis.

- **A "commemorative coin":** federal law authorizes the Treasury to mint a commemorative platinum coin to circumvent the power of Congress. After depositing the coin at the Fed, the Treasury could pay its bills drawing from an account created by the coin without issuing new debt. This solution seems unlikely because the courts would likely question the legal basis for such a move.
- **Issuance « premium bonds":** The Treasury could take advantage of the fact that only principal repayments counts toward the debt ceiling and not interest payments. By issuing new bonds with higher interest rates, the Treasury could reduce the nominal amount of outstanding debt and thus circumvent the debt ceiling. This strategy would obviously be costly because it would increase interest payments.

Although a breach of the debt ceiling is a tail risk, if it occurs, the government will not be able to fully pay its obligations, leading to a *de facto* default. This would be detrimental to the U.S. economy, both because it would require spending cuts and because the U.S. would likely face turmoil in financial market, with a weakening of the dollar and a significant increase in U.S. Treasury yields. Interest rates would rise across the economy and would likely push stock prices down. In this scenario, a sovereign credit rating downgrade seems inevitable and would trigger ratings downgrades for all U.S. debt issuers. A default would also reverberate through international markets, affecting Treasury securities and other U.S. dollar-denominated assets.

An additional challenge for an economy under pressure

The US economy has shown resilience at the beginning of 2023, with a pick-up in consumer spending and a still-strong labour market. However, the outlook is challenging and uncertain.
Inflation, at 4.9% in April 2023, remains too elevated for the Fed to declare victory. We expect interest rates to remain at restrictive levels throughout 2023, even if a negative impact is already being felt in sectors such as housing and is contributing to softer business investment. In addition, two months after the collapse of Silicon Valley Bank, the failure of First Republic Bank raises renewed concerns about the US regional bank industry. Preliminary evidence suggests that banks are responding to this turmoil by tightening credit further.
Coface expects US GDP growth to slow to 1.2% in 2023. Our baseline scenario predicts that the US economy will narrowly avoid a recession this year, but the succession of adverse events in recent weeks could tip it over the edge.

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ISIN Code: FR0010667147 / Mnemonic: COFA

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